Daughters of Charity Health System

College Bowl Case Study 2015

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MEDICAL DEVELOPMENT SPECIALISTS

College Bowl Challenge

You are an executive at Daughters of Charity Health System (Daughters). As a result of Prime Healthcare Services' recent failure to purchase the five Daughters hospitals, you are expected to develop a new contingency plan to address their future operation. You are faced with making strategic decisions for each of the Daughters' facilities that not only incorporates their financial situation but simultaneously ensures the continuation of essential services that the health system operates.

Your contingency plan should contain both strategic and operational issues including maintaining, selling, closing, or changing of operations/services for the facilities. Your contingency plan should include an assessment that addresses the impact on the following:

a. Financial situation
b. Physicians
c. Employees
d. Services
e. Unions
f. Community needs

The following pages provide you with a background on Daughters of Charity Health System. The Appendix includes links to recently completed Health Impact Reports for each of the Daughters of Charity hospitals to further assist you in completing the task.

Background

Daughters of Charity Ministry Services Corporation, a California nonprofit religious corporation (Ministry), is the sole corporate member of Daughters of Charity Health System, a California nonprofit religious corporation. Daughters is the sole corporate member of five California nonprofit religious corporations, including St. Francis Medical Center, St. Vincent Medical Center, O'Connor Hospital, Saint Louise Regional Hospital, and Seton Medical Center (collectively, the Hospital Corporations).

The Hospital Corporations are licensed to operate five general acute care hospitals including St. Francis Medical Center, St. Vincent Medical Center, O'Connor Hospital, Saint Louise Regional Hospital, and Seton Medical Center, which operates under a consolidated license with Seton Medical Center Coastside, a skilled nursing facility (collectively, the Health Facilities).

In 2014, Ministry and Daughters requested the California Attorney General's consent to enter into a Definitive Agreement with Prime Healthcare Services, Inc., a Delaware corporation (Prime Inc.), and Prime Healthcare Foundation, Inc., a Delaware nonprofit non-stock corporation (Prime Foundation), (collectively, Prime), whereby control and governance of Daughters and its affiliated entities would be transferred to Prime Inc. or Prime Foundation, and in some cases, converted to California for-profit business corporations or California nonprofit public benefit corporations.

Prime subsequently failed to complete its bid to purchase the six Health Facilities, citing the lengthy conditions the California Attorney Kamala Harris placed on Prime in approving the transaction. Prime's founder and chairman, Dr. Prem Reddy stated:

> *"The conditions placed on the sale by the California attorney general are so burdensome and restrictive that it would be impossible for Prime Healthcare -- or any buyer - to make the changes needed to operate and save these hospitals."*

Profile of Daughters of Charity Health System

Daughters of Charity Health System

Daughters is a Catholic, nonprofit regional healthcare system headquartered in Los Altos Hills, California. Daughters is sponsored by Daughters of Charity of St. Vincent de Paul, Province of the West, to support the mission of the Catholic Church through their commitment to serving the sick and poor.

Daughters of Charity, a group of women dedicated to caring for the needs of the poor, was established in France by St. Vincent de Paul and St. Louise de Marillac in 1633. The Daughters of Charity continued its mission and opened its first hospital in Los Angeles in 1859. Daughters of Charity expanded its hospitals into San Jose in 1889 and San Francisco in 1893. These establishments were the forerunners of St. Vincent Medical Center, O'Connor Hospital, and Seton Medical Center.

During the 1980s, Daughters of Charity expanded to include Seton Medical Center Coastside (1980), St. Francis Medical Center (1981), and Saint Louise Regional Hospital (1987). In 1986, the Hospital Corporations joined Daughters of Charity National Health System, based in St. Louis, Missouri. In 1995, the Hospital Corporations left Daughters of Charity National Health System and merged with Catholic Healthcare West. When it withdrew from Catholic Healthcare West, Daughters, as presently constituted, was formed in 2001.

Today, Daughters' Health Facilities and their locations include: St. Francis Medical Center in Lynwood, St. Vincent Medical Center in Los Angeles, O'Connor Hospital in San Jose, Seton Medical Center in Daly City, Seton Medical Center Coastside in Moss Beach, and Saint Louise Regional Hospital in Gilroy. Daughters' corporate offices are located in Los Altos Hills, Redwood Shores, and Pasadena.

DCHS Medical Foundation

In 2011, the DCHS Medical Foundation was incorporated with Daughters as the sole corporate member. Under California Health and Safety Code section 1206(l), a clinic operated by a nonprofit corporation that conducts medical research and health education and provides healthcare to its patients through a group of 40 or more physicians and surgeons, who are independent contractors representing not less than 10 board-certified specialties, and not less than two-thirds of whom practice on a full-time basis at the clinic, is not required to be licensed.

The DCHS Medical Foundation began operations in April 2012 through the establishment of a professional services agreement with a group of approximately 200 physicians and associates of the San Jose Medical Group. DCHS Medical Foundation includes 144 full-time physicians as follows:

DCHS MEDICAL FOUNDATION: FULL-TIME PHYSICIANS 2014				
	Physician Count by Market			
Specialty	St. Francis Medical Center / St. Vincent Medical Center	O'Connor Hospital / Saint Louise Regional Hospital	Seton Medical Center / Seton Medical Center Coastside	Total
Family Practice	5	32	1	38
Internal Medicine	3	15	1	19
Hospitalist	-	6	10	16
Acute Care	-	12	-	12
Obstetrics & Gynecology	2	7	-	9
Pediatrics	2	4	-	6
General Surgery	2	2	-	4
Ophthalmology	2	2	-	4
Orthopedic Surgery	3	1	-	4
Podiatry	1	3	-	4
Total Top 10 Specialties	**20**	**84**	**12**	**116**
Other	10	18	-	28
Total Physicians	**30**	**102**	**12**	**144**

Source: Daughters

* Excludes Independent Physician Associations

In 2013, DCHS Medical Foundation acquired Northern Cal Advantage Medical Group, a regional Independent Physicians Association in Santa Clara County, comprised of approximately 200 physicians and nine additional independent physician practices.

Presently, DCHS Medical Foundation consists of urgent care centers, physician groups, and approximately 400 primary care and specialty physicians (including San Jose Medical Group and Northern Cal Advantage Medical Group). With more than 100 physicians, Santa Clara County has the largest medical foundation presence within the system. DCHS Medical Foundation's clinics and facilities are located throughout California in the communities served by the Health Facilities.

Daughters’ Inpatient Volume

Over the past five years, the number of inpatient discharges has declined by nearly 20% to approximately 48,000 discharges in FY 2014. While inpatient discharges decreased by 4.4% between FY 2013 and FY 2014, emergency services increased by 4.6% over the same period.

The following table provides inpatient volume trends for FY 2013 and FY 2014:

DAUGHTERS' TOTAL SERVICE VOLUMES: FY 2013 AND 2014														
	St. Francis Medical Center		St. Vincent Medical Center		O'Connor Hospital		Saint Louise Regional Hospital		Seton Medical Center		Seton Medical Center Coastside		Daughters' Total	
	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014
Licensed Beds	384	384	366	366	358	358	93	93	357	357	121	121	1,679	1,679
Available Beds	382	382	366	366	281	282	93	93	307	294	121	121	1,550	1,538
Discharges	18,957	18,850	9,213	8,244	11,751	10,971	3,021	3,044	7,125	6,755	101	86	50,168	47,950
Patient Days	87,944	87,676	52,946	47,942	52,175	49,663	11,026	10,550	47,479	46,805	38,782	37,382	290,352	280,018
Average Daily Census	241	240	145	131	143	136	30	29	130	128	106	102	795	767
Acute Licensed Beds	314	314	320	320	334	334	72	72	274	274	5	5	1,319	1,319
Acute Available Beds	312	312	253	252	257	258	72	72	224	250	5	5	1,123	1,150
Acute Discharges	16,738	16,329	8,156	7,223	11,725	10,947	3,021	3,044	7,080	6,717	-	-	46,720	44,260
Acute Patient Days	70,073	69,665	38,869	34,634	44,952	41,747	11,026	10,550	33,687	33,039	-	-	198,607	189,635
Acute Average Length of Stay	4.2	4.3	4.8	4.8	3.8	3.8	3.7	3.5	4.8	4.9	-	-	4.3	4.3

Source: Daughters, 2013 Audited & 2014 Unaudited Internal Financials
(1) These figures provided by Daughters differ slightly from OSHPD data reported in subsequent tables, which is cited in the source

Financial Profile

Statement of Operations

DAUGHTERS' STATEMENT OF OPERATIONS: FY 2014 (thousands)												
	St. Francis Medical Center		St. Vincent Medical Center		O'Connor Hospital		Saint Louise Regional Hospital		Seton Medical Center		Daughters' Total (including all other entities)	
	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014	FY 2013	FY 2014
Net Patient Service Revenue	$440,397	$310,816	$191,904	$178,544	$308,334	$260,822	$93,517	$83,636	$257,931	$233,921	$1,352,711	$1,136,719
Provision and Write-Off of Doubtful Accounts	($68,275)	($12,128)	($1,177)	($5,530)	($23,897)	$11,612	($15,144)	($3,399)	($12,732)	($10,218)	($121,836)	($43,282)
Premium Revenue	$33,019	$40,211	$8,593	$10,176	-	-	-	-	-	-	$65,489	$83,298
Other Revenue	$7,523	$3,726	$5,746	$15,499	$9,131	$1,551	$779	$2,518	$6,241	$18,477	$29,433	$60,619
Contributions	$4,146	$5,618	$1,774	$1,889	$1,582	$1,459	$883	$977	$593	$569	$16,723	$157,695
Total Unrestricted Revenues & Other Support	$416,810	$348,243	$206,840	$200,578	$295,150	$272,220	$80,035	$83,732	$252,033	$242,752	$1,342,520	$1,395,049
Salaries and Benefits	$190,873	$196,608	$100,488	$102,314	$188,899	$189,846	$52,270	$57,514	$159,549	$153,681	$783,586	$805,077
Supplies	$30,277	$32,650	$46,151	$42,855	$40,593	$43,301	$7,351	$7,763	$36,258	$35,819	$170,261	$172,346
Provision for Doubtful Accounts	-	-	-	-	-	-	-	-	-	-	-	-
Purchased Services & Other	$134,659	$116,359	$81,531	$71,596	$71,213	$65,807	$22,875	$21,050	$69,289	$58,137	$393,616	$348,086
Depreciation	$17,796	$19,739	$9,882	$12,443	$14,383	$12,762	$4,338	$5,903	$10,428	$10,392	$60,439	$65,786
Net Interest	$7,026	$5,158	$4,894	$3,379	$5,060	$3,504	$2,771	$1,985	$5,840	$3,725	$25,336	$19,355
Total Expenses	$380,631	$370,514	$242,946	$232,587	$320,148	$315,220	$94,605	$94,215	$381,364	$261,754	$1,433,238	$1,410,650
Operating Income	$36,179	($22,271)	($36,106)	($32,009)	($24,998)	($43,000)	($14,570)	($10,483)	($29,331)	($19,002)	($90,718)	($15,601)
Investment Income	$8,394	$6,676	$994	$674	$2,210	$271	$49	$35	$1,028	$52	$16,252	$16,315
Excess (Deficit) of Revenues Over Expenses	$44,573	($15,595)	($35,112)	($31,335)	($22,788)	($42,729)	($14,521)	($10,448)	($28,303)	($18,950)	($74,466)	$714

Source: Daughters, 2013 Audited & 2014 Internal Unaudited Financials

Daughters’ internal unaudited statement of operations for FY 2014 displays the individual performance of the Health Facilities in conjunction with Daughters’ system-wide performance. The individual Health Facilities show operating losses, as well as deficits of revenue over expenses. On a system-wide basis, Daughters also reports an operating loss, though this is offset by income from investment activities (unadjusted for a substantial non-recurring item related to the favorable treatment in redeeming the 2008 Bonds).

Net Patient Service Revenue

Net patient service revenue (less provision for bad debts) of $1.1 billion represents a net decrease of $137.4 million (11.2%) as compared to FY 2013. Net patient service revenue during FY 2014 included $45.1 million in revenue from DCHS Medical Foundation, as compared to $33.4 million for FY 2013. Additionally, net patient service revenue for FY 2014 was impacted by a decrease of $119.9 million in Hospital Qualified Assurance Fee Program[1] revenue.

Operating Expenses

Total operating expenses of $1.410 billion for FY 2014 represent a decrease of 1.6% from FY 2013. A portion of the net decrease may be attributed to the inclusion of $111.1 million in operating expenses from DCHS Medical Foundation, as compared to $75.7 million during FY 2013, as well as a decrease of $64.2 million in Hospital Qualified Assurance Fee Program expenses. Daughters' salaries and benefits amounted to nearly 70% of total expenses. This is significantly higher than the average percentage for all nonprofit general acute care hospitals in California (49% in FY 2013).

Non-Recurring Items

Daughters' statement of operations includes a large non-recurring item related to the favorable accounting treatment of the 2008 Bond Redemption in the amount of $130 million. Inclusion of this item has the effect of overstating operating income. Adjusting for this non-recurring item, FY 2014 shows an operating loss of $146.3 million and a net income loss of $130 million.

Historic Comparison

The table below displays adjusted operating/net income figures for FY 2014, as well as similar figures for FY 2011- FY 2013. Over the past several years, Daughters' operating losses have significantly increased due to changes in declining reimbursement, declining volume, and increasing salary costs. Between FY 2010 to FY 2014, Daughters reported an operating loss of between $49.4 million in 2010 to over $146.3 million in FY 2014.

In addition, Daughters' days cash on hand has significantly declined due to pressure from the operating losses. Days cash on hand measures the period of time in which the organization is able to meet cash requirements in the absence of outside funding. This ratio may be influenced by a variety of cash flow inflows or outflows, though higher figures generally indicate better liquidity and a safer margin to meet outflow obligations. Based on

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[1] Hospital Qualified Assurance Fee Program: This program uses fees assessed by the state on hospitals to draw down federal matching funds. These provider fees are then issued as supplemental payments to hospitals. These provider fees are an integral element to improving access to healthcare for some of California's most vulnerable residents.

internal financial projections, Daughters expects to run out of cash by the third quarter of FY 2015 (January-March) without financial intervention.

The following table reports additional trends in operating income, net income, labor costs, and liquidity from FY 2010 through FY 2014:

DAUGHTERS' FINANCIAL TRENDS: FY 2010-2014	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Operating Income[1] (millions)	(49.4)	(44.6)	(61.0)	(90.7)	(146.3)
Net Income (millions)	(18.8)	(4.1)	(59.5)	(74.5)	(130.0)
Labor Costs as a % of Net Patient Service Revenues	65.3%	59.2%	61.9%	63.7%	73.6%
Days Cash on Hand	93	87	70	50	31

Source: Daughters, 2014 Unaudited

(1) 2014 operating income excludes the favorable accounting treatment of the 2008 bond redemption

- Due to a $54 million net provider fee benefit, the operating income improved slightly in FY 2011, before declining in FY 2012, FY 2013, and FY 2014;

- Labor costs as a percentage of net patient service revenues have continued to increase to nearly 74% in FY 2014. This is higher than the industry as compared to Standard & Poor's Rating Service Not-For-Profit Healthcare System Median of 57.7%; and

- Liquidity levels are significantly lower than Standard & Poor's Rating Service Not-For-Profit Healthcare System Median of 204.6 days cash on hand.

Cash Position & Debt Obligations

Between FY 2013 and FY 2014, total cash and marketable securities decreased by $82.8 million (31% decrease), and total unrestricted cash and marketable securities decreased by $74.6 million (40% decrease). Over the same time period, unrestricted days cash on hand decreased by 38%, from 50 days in FY 2013 to over 31 days in FY 2014. Daughters' mounting declines in days cash on hand is one indicator of liquidity challenges.

The following table reports the summary of Daughters' outstanding obligations as of FY 2014:

DAUGHTERS' SUMMARY OF OUTSTANDING OBLIGATIONS: FY 2014	
Obligation	Amount (millions)
Total Trade, Employee, and Other Obligations	$185
2005 Bonds	$290
Other Long-Term Debt	$6
Total Short- and Long-Term Debt	**$481**
Total Unfunded Retirement Plan Liabilities	$278
Total Short-Term and Long-Term Obligations	**$759**

Source: Daughters, Unaudited Financials, 2014
(1) Excludes the $125 million 2014 Bonds

In order to address the liquidity shortage and outstanding obligations, Daughters of Charity Foundation[2] made a restricted donation of $130 million for the benefit of Daughters in October 2013. On October 25, 2013, Daughters redeemed the 2008 Bonds, consisting of the $130 million donation and a $13.7 million reserve fund, totaling $143.7 million in redemptions. The effect of the non-recurring donation on the Statement of Operations for FY 2014 is covered in the previous section.

Additionally, Daughters accessed a $125 million short-term financing bridge loan in August 2014 to provide enough days cash on hand to support operations through the end of FY 2015. The bridge loan consists of the $100 million 2014 Bonds (Series A), the $10 million 2014 Bonds (Series B), and the $15 million 2014 Bonds (Series C). The bridge loan matures on July 10, 2015 and is dependent upon ensuring that the sale of all Daughters' assets is completed in a timely manner.

Credit Rating & Outlook

In April 2014, Standard & Poor's Rating Service downgraded certain bond issuances of Daughters from "BBB-" to "B-." A rating of "B-" represents less-than-investment grade status. An issuers' credit quality is generally reflective of its financial condition and ability to meet ongoing debt service obligations. A downgrade can pose future challenges for an issuer to raise capital in the debt markets as the cost of debt rises because buyers of lower rated bonds require higher rates of return to justify the greater relative risk incurred. Some of the following reasons were cited for Standard & Poor's Rating Service downgrade:

- Escalating operating losses during the past several years;

[2] Daughters of Charity Foundation engages in the solicitation, receipt, and administration of contributions and their disbursements to and for the benefit of the ministries of Daughters of Charity of St. Vincent de Paul, Province of the West.

- Substantial loss from operations through the first half of FY 2014;
- Continued weakening of the balance sheet despite substantial debt refunding as a result of the restricted donation made by Daughters of Charity Foundation in the amount of $130 million in October 2013;
- Eroding unrestricted reserves;
- Lack of a merging and/or acquiring entity (at the time of Standard & Poor's Rating Service decision);
- Heavy reliance on hospital provider fee benefits and disproportionate share receipts3 to help offset operating losses; and
- Substantially underfunded pension plans, with a 50% funded status based on projected benefit obligations as of June 30, 2013.

At the time of the downgrade, Standard & Poor's Rating Service anticipated further operating losses through the second half of FY 2014. Additional downgrade potential was cited within the one-year outlook period if Daughters' divestiture plans were not finalized. This underscores the belief that the system would continue its operational difficulties on a stand-alone basis without outside intervention. Also there is the concern of continued operating pressures and the view that the balance sheet offers a "very limited cushion" to absorb continued losses.

Financial Distress & Divestiture Plans

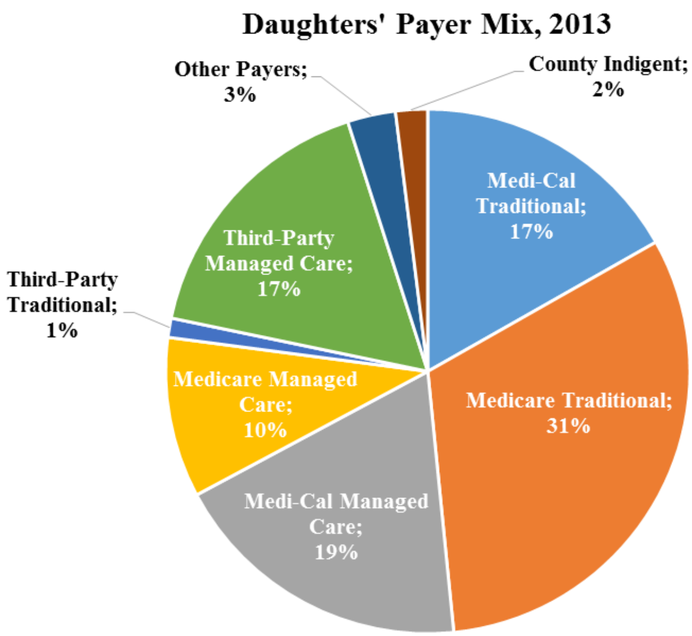
The declining financial condition of Daughters is documented in both audited and unaudited financial statements, credit rating action, and internal communications. Prior to the credit rating downgrade, internal communications and Daughters' Board meeting minutes in late 2013 reflected a growing concern of system-wide insolvency and the need to secure options.

At a subsequent Daughters' Board meeting on December 24, 2013, a motion was approved selecting Houlihan Lokey as a financial advisor. Its directive was to guide Daughters' Board in entertaining solutions and to include staffing in the contract. An offering process was undertaken for the sale of Daughters' assets and liabilities.

[3] Disproportionate Share Hospitals serve a significantly disproportionate number of low-income patients and receive payments from the Centers for Medicare & Medicaid Services to cover the costs of providing care to uninsured patients.

Daughters' Payer Mix

In FY 2013, approximately 31% of Daughters' inpatient payer mix consisted of Medicare Traditional, 19% consisted of Medi-Cal Managed Care, 17% consisted of Medi-Cal Traditional, and 17% consisted of Third-Party Managed Care. The remaining 16% of Daughters' inpatient discharges consisted of Medicare Managed Care (10%), Other Payers* (3%), County Indigent (2%), and Third-Party Traditional (1%) payers.



Total Discharges: 47,950

* "Other" includes self-pay, workers' compensation, other government, and other payers

Source: OSHPD Financial Disclosure Report, FY 2013 (based on inpatient discharges)

Unionized Employees

Daughters has relationships with various unions across the State of California, including a system-wide CBA with Service Employees International Union, United Healthcare Workers West, that covers over 2,800 employees at the Health Facilities for the period of May 1, 2012 through April 30, 2015. In addition, each of the Health Facilities has CBAs with other unions, including California Nurses Association, California Licensed Vocational Nurses Association, United Nurses Associations of California/Union of Health Care Professionals, International Union of Operating Engineers, Local 39, and Engineering Scientists of California, Local 20. In 2013, Daughters reported approximately 7,650 employees, with nearly 74% covered under CBAs.

UNION PARTICIPATION AMONG DAUGHTERS' EMPLOYEES						
Union	**St. Francis Medical Center**	**St. Vincent Medical Center**	**O'Connor Hospital**	**Saint Louise Regional Hospital**	**Seton Medical Center & Seton Medical Center Coastside**	**Total**
Service Employees International Union, Local 250	543	419	496	274	703	2,435
Service Employees International Union, Local 250 Technical	286	-	137	-	-	423
California Nurses Association	-	364	750	269	475	1858
California Licensed Vocational Nurses Association	-	-	27	8	-	35
International Union of Operating Engineers, Local 39	-	-	17	11	22	50
United Nurses Association of California	762	-	-	-	-	762
Engineering Scientists of California, Local 20	-	-	41	17	33	91
Total	**1,591**	**783**	**1,468**	**579**	**1,233**	**5,654**

Source: Daughters

Appendix

St. Francis Medical Center Health Impact Report

https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/pdf/st-francis-medical-center-ag-report.pdf?

St. Vincent Medical Center Health Impact Report

https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/pdf/st-vincent-medical-center-ag-report.pdf?

O'Connor Hospital Health Impact Report

https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/pdf/oconnor-hospital-ag-report.pdf?

Saint Louise Regional Hospital Health Impact Report

https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/pdf/saint-louise-hospital-ag-report.pdf?

Seton Medical Center Health Impact Report

https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/pdf/seton-medical-center-ag-report.pdf?